

INDEPENDENT AUDITOR'S REPORT



Department of Veterans Affairs Office of Inspector General

REPORT OF THE AUDIT OF THE DEPARTMENT OF VETERANS AFFAIRS CONSOLIDATED FINANCIAL STATEMENTS FOR FISCAL YEARS 2002 AND 2001

Report No. 02-01638-47

January 22, 2003

VA Office of Inspector General
Washington, DC 20420



DEPARTMENT OF VETERANS AFFAIRS
Office of Inspector General
Washington DC 20420

Memorandum to the Secretary

**Report of Audit of the Department of Veterans Affairs Consolidated
 Financial Statements for Fiscal Years 2002 and 2001**

1. Attached is the Report of Audit of the Department of Veterans Affairs (VA) Consolidated Financial Statements (CFS) for Fiscal Years (FY) 2002 and 2001. The Chief Financial Officers Act of 1990 requires this audit. The OIG contracted with the independent public accounting firm Deloitte & Touche LLP to perform the audit of VA's FY 2002 CFS. The OIG defined the requirements of the audit, reviewed the audit plans, monitored the audit, and reviewed the draft reports.
2. The independent auditors' report by Deloitte & Touche LLP provides an unqualified opinion on VA's FY 2002 and 2001 CFS. The report on internal control identifies five reportable conditions, of which two are material weaknesses. These five findings were reported last year. The two material weaknesses are (i) information technology security controls and (ii) integrated financial management system. The three reportable conditions are (i) application program and operating system change controls, (ii) loan guaranty business process, and (iii) operational oversight. Furthermore, the FY 2001 report on internal control contained five material weaknesses and six reportable conditions. During FY 2002, VA management has taken corrective action to eliminate three of the material weaknesses and two of the reportable conditions reported in the FY 2001 report. Two of the FY 2001 material weaknesses were combined into one information technology security controls finding this year.
3. The report on compliance with laws and regulations continues to conclude that VA is not in substantial compliance with the financial management system requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996. The internal control issues concerning an integrated financial system and information technology security controls indicate noncompliance with the requirements of Office of Management and Budget (OMB) Circular A-127, "Financial Management Systems," which incorporates by reference OMB Circulars A-123, "Management Accountability and Control," and A-130, "Management of Federal Information Resources."
4. The material weakness and FFMIA noncompliance issues concerning VA's financial management systems underscore the importance that VA must continue its efforts to acquire and implement a replacement integrated core financial management system. The auditors' unqualified opinion was achieved for the most part through the extensive efforts of program and financial management staff, as well as the auditors, to overcome material weaknesses in internal control to produce auditable information after the fiscal year-end. Although these efforts resulted in materially correct annual financial statements, reliable information was not readily available during the year. The risk of materially misstating financial information is high with the existing financial management systems.
5. We will follow up on these internal control findings and evaluate any corrective actions during the audit of the Department's FY 2003 Consolidated Financial Statements.

MICHAEL SLACHTA, JR.
 Assistant Inspector General for Auditing

Attachment

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INDEPENDENT AUDITORS' REPORT

To the Secretary
Department of Veterans Affairs

We have audited the accompanying consolidated balance sheets of the Department of Veterans Affairs (VA) as of September 30, 2002 and 2001, and the related consolidated statements of net cost, changes in net position, financing and the combined statement of budgetary resources for the years then ended (collectively referred to as the financial statements). These financial statements are the responsibility of the management of VA. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and the requirements of Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and the OMB Bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of VA as of September 30, 2002 and 2001, and its net costs, changes in net position, budgetary resources and financing for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Footnote 22, the VA changed its capitalization threshold from \$25,000 to \$100,000.

As discussed in Footnote 22, the VA adopted the changes in the OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*. These changes included revisions in some of the titles of basic financial statements as well as several changes in the presentation in the financial statements and related footnotes.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 2, 2002, on our consideration of VA's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

A handwritten signature in black ink that reads "Deloitte & Touche LLP".

December 16, 2002



INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Secretary
Department of Veterans Affairs

We have audited the financial statements of the Department of Veterans Affairs (VA), as of and for the year ended September 30, 2002, and have issued our report thereon dated December 16, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the requirements of the Office of Management and Budget (OMB) Bulletin No. 01-02, “*Audit Requirements for Federal Financial Statements*”, as amended.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit, we considered VA’s internal control over financial reporting by obtaining an understanding of the agency’s internal control, determining whether internal controls had been placed in operation, assessing control risks, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect VA’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

We identified the following matters involving the internal control over financial reporting and operation that we consider to be material weaknesses and other reportable conditions as defined above. Material weaknesses and other reportable conditions that we identified in our prior year report dated February 19, 2002 are identified as repeat conditions. The material weaknesses and the reportable conditions are categorized under the headings Information Technology and Operations.

Five reportable conditions are described in the following paragraphs and include significant departures from certain requirements of OMB Circular A-127, "Financial Management Systems," which incorporates by reference Circulars A-123, "Management Accountability and Control," and A-130, "Management of Federal Information Resources," among other requirements. We believe that the two reportable conditions identified as "Information Technology (IT) Security Controls" and "Integrated Financial Management System," are also material weaknesses.

INFORMATION TECHNOLOGY

Information Technology (IT) Security Controls – Material Weakness

(Repeat Condition)

VA's program and financial data continue to be at risk due to serious weaknesses related to the Department's control and oversight over access to its information systems. These weaknesses placed sensitive information, including financial data and sensitive veteran medical and benefit information, at risk of inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction, possibly occurring without detection. The VA Office of Inspector General (OIG) first reported this condition in its fiscal year 1997 audit report and made recommendations for VA to implement a comprehensive security program that would improve these controls. VA has acknowledged these weaknesses and first reported IT security controls as a material weakness in its Federal Managers' Financial Integrity Act (FMFIA) report for fiscal year 1998.

Our testing of key controls over security administration for the core Financial Management System (FMS), the payroll system (Personnel and Accounting Integrate Data – PAID) and the veterans compensation and pension benefit payment system (Compensation & Pension System – C&P) and the OIG's testing for Government Information Security Reform Act (GISRA) reporting identified the following control weaknesses:

- In the FMS system, we identified numerous security weaknesses, including inadequate segregation of duties over security administration; inappropriate access privileges and inadequate management of access privileges; excessive assignment of powerful override privileges; and inadequate segregation of duties permitting individuals to both obligate funds and make disbursements.
- In the PAID system, we identified numerous security weaknesses, including inadequate segregation of duties over security administration; inappropriate access privileges and inadequate management of access privileges; and inadequate segregation of duties permitting individuals to make changes to the payroll master file and process payroll transactions.
- In the C&P system, we identified numerous security weaknesses, including inappropriate access privileges and inadequate management of access privileges; excessive assignment of powerful privileges to sensitive information; and inadequate segregation of duties permitting individuals to both initiate claims and authorize the claims for disbursement.

- The Office of Inspector General (OIG) performed penetration tests of the VA systems. Internal penetration tests (accessing systems from inside VA's network) verified that VA's automated systems could be exploited to gain access to sensitive veterans' benefit and healthcare information. The nature and the number of vulnerabilities found warrant immediate attention to reduce the significant exposure and high risk of an internal attack.
- External penetration tests (accessing systems from outside VA's network) found that the VA's automated systems with protection controls could not be penetrated. The OIG's attempts to access systems through Internet connections at facilities with protection controls were identified, prevented and reported to the VA Computer Incident Report Center (VA-CIRC). The OIG testing confirmed that VA should implement external automated system protection measures Department-wide to adequately protect its systems and sensitive data.

During both the fiscal years 2002 and 2001 audits, we observed control weaknesses in critical loan guaranty applications system security and process controls due to a lack of accountability and definition of responsibility for implementing and enforcing consistent security administration standards and the lack of appropriate reconciliation processes/procedures. These weaknesses increase the risk of unauthorized or erroneous data transfer, and modifications of production programs and data, resulting in unreliable loan and property data that feed VA's core financial management system. Additionally, the lack of appropriate reconciliation of loan guaranty data among systems does not permit the Veterans Benefits Administration (VBA) the ability to detect unauthorized or erroneous data. Such weaknesses include the following:

- Excessive access to Common Security Administration Manager functions that control access to Automated Loan Production System and Loan Servicing & Claims System (LS&C) functions and data;
- Lack of accountability and responsibility for security administration and oversight of access to the Property Management System (PMS) and the Guaranty/Insured Loan System (GILS);
- Lack of clearly defined responsibility for monitoring powerful user activities and transactions within Loan Guaranty System applications;
- Inadequate business continuity planning and testing of systems infrastructure supporting Loan Guaranty Systems; and
- Inconsistent application development and change management standards and compliance with established standards for application changes, testing, acceptance and quality assurance.

VA's success in improving information security is dependent on VA comprehensively addressing these weaknesses at an enterprise level, including obtaining a high level of commitment and establishing appropriate accountability throughout VA; and obtaining adequate resources to implement the plan.

Recommendation

We reaffirm our prior year recommendations and the OIG's recommendation in the GISRA report that VA:

1. Apply appropriate resources and accountability mechanisms in order that the planned actions be accomplished within an acceptable timeframe and will remediate the deficiencies identified in the GISRA process.

2. Correct and or eliminate the information security vulnerabilities exploited during the penetration testing of VA information systems and implement VA-wide policy to effectively monitor network operations to include the use of scanning and penetration testing techniques.
3. Improve security and segregation of duties controls over the FMS, PAID and C&P application systems, and assign, communicate, and coordinate responsibility for monitoring and enforcing such controls, throughout VA.
4. Improve security and business process controls over loan guaranty processes and application systems, and assign, communicate, and coordinate responsibility for monitoring and enforcing such controls, throughout the Veterans Benefits Administration.

Application Program and Operating System Change Controls

(Repeat Condition)

We noted continuing weaknesses in application program change controls and operating system software change controls at certain VA data centers. Weaknesses include: inappropriate access capabilities by application programmers and system support staff to production data; lack of application change procedures; inadequate procedures for testing, approving, and migrating system software changes; inadequate segregation of duties for approving, performing, testing and documenting operating system software changes; and inadequate application program change tracking procedures. These weaknesses may cause unauthorized or invalid program and operating system changes to be placed into production.

Recommendation

5. We reaffirm our prior year's recommendation that improved controls over application program and operating system changes be instituted, communicated and enforced throughout the data centers.

OPERATIONS

Integrated Financial Management System – Material Weakness

(Repeat Condition)

As defined in OMB Circular A – 127, “a financial management system encompasses automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.” Such financial management systems shall be designed to provide for an effective and efficient interrelationship between software, hardware, personnel, procedures, controls, and data contained within the systems.

With respect to system requirements in the area of financial reporting, OMB Circular A – 127 provides that an agency's financial management system should generate reliable, timely, and consistent information necessary for meeting management's responsibilities, including the preparation of financial statements. Within OMB Circular A – 123, the management control processes necessary to ensure that “reliable and timely information is obtained, maintained, reported and used for decision making” are set forth, including prompt and appropriate recording and classification.

During our audit of VA's consolidated financial statements, we noted continuing difficulties related to the preparation, processing, and analysis of financial information to support the efficient and effective preparation of VA's consolidated financial statements. While significant efforts are made at the component and consolidated levels to assemble, compile, and review the necessary financial information for annual financial reporting requirements; in many cases, significant manual work-arounds and out-of-date feeder systems are still in place as VA has not yet completed its transition to a fully integrated financial management system. For example, we noted that:

- In the Veterans Health Administration (VHA), some medical centers were not performing account reconciliations on a consistent basis and assets were not capitalized in a timely manner.
- VBA management identified 10,081 direct loans that were not fully amortized. These loans are expected to have an unpaid principal balance of \$49.7 million on their scheduled maturity dates. VBA management provided a detail analysis of the loans. They asserted that the likely unpaid balance of direct loans that will reach maturity for which VA would have limited recourse would be approximately \$3 million.
- Also in VBA, a comparison of the Foreclosed Property data extract and Countrywide Home Loans (CHL)'s database for the period ending August 31, 2002 indicated that approximately 1,500 records totaling \$44 million were incorrectly included in the property management database.

Given the size and complexity of the VA, as well as the current status of the system development and implementation cycles for planned improvements, it is critical that enhanced control, monitoring and reconciliation processes be in place and functioning appropriately throughout the year to ensure accurate and complete financial reporting.

Recommendation

6. We affirm our prior year's recommendation that even though fully automated processes may not yet be in place, supplemental manual processes should be implemented and enforced to meet appropriate control objectives.
7. More frequent preparation of financial statements during the year would ensure that supporting analyses and reconciliations are completed and reviewed. While this would be a substantial undertaking, we recommend that VA prepare monthly financial statements and implement a plan to attain that goal over the next few years. The transition of the closing process from annually to monthly could begin with semi-annual closes, and then move to quarterly closes as the financial reporting process matures.

Loan Guaranty Business Process

(Repeat Condition)

During both the fiscal years 2002 and 2001 audits, procedures were performed focusing on the business processes of the Loan Guaranty (LGY) Program. We noted areas for improvement in the business process environment. There are many interfaces among LGY modules and FMS ledger accounts. These interfaces capture and transmit loan and property data, and update FMS with such data. VBA does not have an

effective means to ensure that responsible officials or individuals routinely and consistently perform data reconciliations and resolve transaction discrepancies in a timely manner. For example, we observed the following:

- The Mortgage Loan Accounting Center (MLAC) produces a Microsoft Access report that compares property values in FMS with values in PMS. There were differences noted between FMS and PMS. While efforts were made by MLAC to investigate and resolve the differences, there remained an unreconciled difference that was not resolved.
- The Guaranteed Insured Loan System (GILS) creates an “Errors File” when it receives incorrect / incomplete data from the Automated Loans Processing System (ALPS). We were not able to determine which offices are responsible for reviewing reported errors, and whether such errors were investigated and resolved on a timely basis,
- The Loan Services and Claims (LS&C) system updates both FMS and PMS, but the PMS data file is updated a day later than FMS. Currently, there is no report to reconcile the data transferred between LS&C and PMS. This could result in inconsistent property information being recorded in FMS and PMS.

Recommendation

8. We reaffirm our prior year’s recommendation that VBA continue to make efforts to reconcile and resolve existing differences between LGY modules (including GILS, PMS, and LS&C) and FMS.
9. VBA develop and implement clear responsibilities and appropriate procedures to routinely reconcile, investigate and resolve data transaction discrepancies to ensure that consistent information is maintained in all databases. The system should generate well-structured reconciliation reports to facilitate routine reviews of data transfers and easy documentation of such reviews.
10. VBA should develop reports to facilitate reconciliation of differences between ALPS and GILS, as well as LS&C and PMS. Further, VBA should define critical interfaces among LGY modules and FMS systems, and design and use comparable reports to facilitate routine reconciliation of key interfaces.

Operational Oversight

(Repeat Condition)

During our audit, we conducted site visits to selected VA medical centers or stations within the Veterans Integrated Service Networks (VISNs) to test compliance with identified control and reconciliation processes. We continued to note a number of previously reported instances where application of control and reconciliation processes were not performed consistently or completely. If the condition existed at over 25% of the sites, then we deem the condition to be significant noncompliance. In several instances, existing Department procedures for supervisory review were not applied consistently or timely. Examples include instances where medical centers were not adequately billing some medical services to patients with third party insurance. Individuals had multiple obligation and payment authority. This precluded a proper separation of duties. We frequently observed ineffective or inefficient processes in the areas of property, plant and equipment; medical accounts receivable; and accounts payable during our site visits.

Recommendation

11. We reaffirm our prior year's recommendation that procedures for appropriate and timely management reviews, separation of duties and account reconciliations be formalized and implemented to achieve improved internal control over financial reporting. VHA Management should improve the monitoring of existing policies and procedures implemented.

Follow-up on Previous Report

In our report in connection with the fiscal year 2001 VA financial statements dated February 19, 2002, we reported eleven reportable conditions (with six material weaknesses) in the areas of (1) Management Ownership of Financial Data, (2) Reliance on Independent Specialists, (3) Management Legal Representations, (4) Information Technology (IT) Security Controls, (5) Loan Guaranty Application Systems, (6) Application Program and Operating System Change Controls, (7) Business Continuity and Disaster Recovery Planning, (8) Integrated Financial Management System, (9) Authorization of Compensation Benefit Claim Payments, (10) Loan Guaranty Business Process and (11) Operational Oversight. As discussed earlier, we believe items (1), (2), (3), (7) and (9) have been corrected. The material weaknesses repeated in fiscal year 2002 are items (4), (5) and (8). Items (4) and (5) have been combined into one material weakness. Items (6), (10) and (11) remain as reportable conditions in fiscal year 2002.

* * * * *

With respect to the internal control related to performance measures reported in Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not provide an opinion on such controls.

In addition, we considered VA's internal control over Supplementary Information by obtaining an understanding of VA's internal control, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin 01-02. Our procedures were not designed to provide assurance on these internal controls. Accordingly, we do not provide an opinion on such controls.

COMPLIANCE

VA management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether VA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*, and are described below.

Under FFMIA, we are required to report whether the agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U. S. Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance and evaluative criteria issued by OMB in Circular A-127.

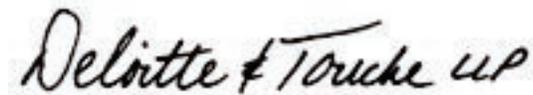
The material weaknesses in internal control over financial reporting discussed above and identified as "Integrated Financial Management System" and "Information Technology (IT) Security Controls", indicate that VA is not in full compliance with the requirements of OMB Circulars A – 123, A – 127, and A - 130. As discussed above, we found material weaknesses in (1) the design and operation of internal controls over financial reporting, particularly with effectiveness of the control, monitoring and reconciliation processes in support of the preparation of the Department's consolidated financial statements, given the status of the transition to a fully integrated financial management system; and (2) the effectiveness of the information technology security controls.

We believe these material weaknesses, in the aggregate, result in departures from certain of the requirements of OMB Circulars A–123, A–127 and A-130, and are, therefore, instances of substantial noncompliance with the Federal financial management systems requirements under FFMIA.

However, we noted other matters involving the internal control and compliance over financial reporting that we have reported to management of the VA, in a separate letter dated December 16, 2002.

DISTRIBUTION

This report is intended solely for the information and use of the Office of Inspector General of the Department of Veterans Affairs, the management of the Department of Veterans Affairs, the Office of Management and Budget, the U. S. General Accounting Office, Office of the President and the U. S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Deloitte & Touche LLP". The signature is written in a cursive, flowing style.

December 16, 2002

Date: DEC 24 2002

From: Assistant Secretary for Management (004)

Subj: Report of Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2002 and 2001

To: Assistant Inspector General for Auditing (52)

We have reviewed the Report of the Office of Inspector General Audit for Fiscal Years 2002 and 2001, and are pleased with receipt of an unqualified opinion. The planning and efficient performance of all staff involved in this year's audit ensured completion of the audit 2 months ahead of the required date -- an exceptional accomplishment. Please extend to your staff, and the staff of Deloitte and Touche, LLP, our appreciation for their hard work and cooperation during this year's audit.

We will share the results of the audit, as well as the findings on internal controls over financial reporting and regulatory compliance, with senior officials in the Veterans Health Administration and Veterans Benefits Administration, and with other VA staff and program managers. We will continue to provide you with updates on the progress implementing our management plan to correct the two material weaknesses, Integrated Financial Management System and Information Technology Security Controls.

Thank you again for all your hard work that brought us to another successful conclusion of the audit cycle. If you have any questions, please contact me at 273-5589.


William H. Campbell